DEPARTMENT OF STATE REVENUE

02-20110473. LOF

LETTER OF FINDINGS: 02-20110473
Corporate Income Tax
For Tax Years 2006-2008

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ISSUES

I. Adjusted Gross Income Tax – Sales Apportionment Methodology.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-6-10; IC § 4-21.5-2-4; IC § 4-21.5-1 et seq; IC § 4-22-2-3; 45 IAC 3.1-1-37; 45 IAC 3.1-1-39; 45 IAC 3.1-1-62; 45 IAC 15-4-1; Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); CBS Inc. v. Comptroller, 575 A.2d 324 (Md. 1990); Metromedia, Inc. v. Director, Division of Taxation, 478 A.2d 742 (N.J. 1984).

Taxpayer is protesting the Department's use of the "audience factor" apportionment method to determine the tax due on income derived from television stations which broadcast in Indiana.

II. Adjusted Gross Income Tax – Consolidation – Entities Added to Indiana Return.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-2; 45 IAC 3.1-1-38; 45 IAC 3.1-1-55.

Taxpayer protests the inclusion of two media companies in its Indiana consolidated returns for the years at issue.

STATEMENT OF FACTS

Taxpayer is a major media corporation engaged in television and motion picture production and distribution, and television broadcasting, among other businesses. Taxpayer filed consolidated adjusted gross income tax returns in Indiana for the tax years. The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer for the years 2006 through 2008. As a result of the audit, the Department made several proposed adjustments which resulted in the assessment of additional income tax as well as interest for 2006 and 2007. For 2008, the Department's audit resulted in an increased net operating loss. Taxpayer protested some of the adjustments. A hearing was held on Taxpayer's protest and this Letter of Findings results. Additional information will be provided as necessary.

I. Adjusted Gross Income Tax – Sales Apportionment Methodology.

DISCUSSION

Taxpayer protested the Department's proposed assessment of additional income tax based on the use of the "audience factor" apportionment methodology in lieu of the "cost of performance" apportionment methodology Taxpayer used, arguing that the "audience factor" method has not been adopted in Indiana either by statute or regulation. Taxpayer argues that IC § 6-3-2-2(f) requires companies with revenue from sales, other than sales of certain intangible property or tangible personal property, to apportion such revenue using a "cost of performance" method. Taxpayer then cites to 45 IAC 3.1-1-62 to argue that the Department did not have the authority to apply its equitable remedial powers under IC § 6-3-2-2(l). Taxpayer states in its protest letter:

> The regulation further provides that '[i]t is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

Indiana imposes the adjusted gross income tax ("AGIT") on every corporation's adjusted gross income ("AGI") derived from sources within Indiana. IC § 6-3-2-1(b). When a corporation derives business income from sources both within and without Indiana, the business income derived from sources within Indiana is determined by an apportionment formula. See IC § 6-3-2-2(b). The term apportionment refers to the division of multistate income among the states by use of a three factor, or any other approved formula. 45 IAC 3.1-1-37.

For the years in question, Indiana's three factor formula multiplied the income derived from sources both within and without Indiana by a fraction, the numerator of which was a property factor plus a payroll factor plus a sales factor, with the sales factor weighted more heavily, and the denominator of which was the sum of the weights assigned to each factor. IC § 6-3-2-2(b). The numerator of each factor represented business conducted in Indiana, and the denominator of each factor represented business conducted everywhere. Stated differently, three-factor apportionment calculated the mathematical average of three ratios: (i) intrastate property to property everywhere; (ii) intrastate payroll to payroll everywhere; and (iii) intrastate sales to sales everywhere. Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766, 771–72 (Ind. Tax Ct. 1999).

Excluding amounts from the numerator of an apportionment factor lowers the percentage of a company's income that is apportioned to a state; adding amounts to the numerator increases the percentage of a company's income that is apportioned to a state. Apportionment disputes arise because, among other reasons, a company

excludes an amount from the numerator of a factor and a state believes such amount should be included in the numerator of the factor.

In rare cases, three-factor apportionment does not fairly represent a corporation's income derived from sources within Indiana. Accordingly, the General Assembly has identified two circumstances in which the Department is empowered to equitably apportion a corporation's income to fairly reflect the income from sources in Indiana.

IC§ 6-3-2-2(l), which says:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (1) separate accounting;
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> (2) the exclusion of any one (1) or more of the factors;
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> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
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> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(Emphasis added).

The second circumstance is at IC § 6-3-2-2(m), which says:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

IC § 6-3-2-2(p) pertains to the Department's power to require two or more businesses to file a combined Indiana income tax return.

Consistent with the Department's statutory power to equitably apportion multistate income, see IC § 6-3-2-2(l), the Department's rules state that three-factor apportionment applies unless the Department requires "the use of a different formula which more fairly reflects" the corporation's income from Indiana sources. 45 IAC 3.1-1-39. The Department will equitably apportion a corporation's income if the corporation's reporting method (i) does not "fairly represent" the corporation's Indiana income; or (ii) results in an "arbitrary division" of income; or (iii) "in other respects does not fairly attribute income to this state or other states." 45 IAC 3.1-1-62 (citing IC § 6-3-2-2(l)). In such cases, "the Department may require the use of a more equitable formula for determining Indiana income." 45 IAC 3.1-1-62. "It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results." Id.

The present dispute starts with the sales factor of Indiana's three-factor apportionment formula. In relevant part, Indiana's sales factor says:

> The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property.... Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter....
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> IC § 6-3-2-2(e).
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> Sales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if:
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> (1) the income-producing activity is performed in this state; or
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> (2) the income-producing activity is performed both within and without this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.
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> IC § 6-3-2-2(f).
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> Taxpayer argued that its services originate primarily in two states outside Indiana, and that, therefore, the income-producing activities related to affiliate and advertising revenue are attributable to those states. However, as the Department's audit points out, both of these states' laws source this revenue to where the programming is delivered and apportion accordingly among the states; i.e., neither state taxes the portion of income that is derived from television viewers in other states. The Department's auditor requested from Taxpayer documentation that would include the 50-state apportionments necessary to explain the nature and types of revenue earned. According to Taxpayer, Taxpayer provided the requested documents. The Department's audit concluded that the "audience factor"–based on "using the Nielsen's audience factor ratio"–more fairly reflects Indiana income since revenues earned by Taxpayer are based on the number of subscribers and is consistent with the use of "audience factor" in other states such as the states where Taxpayer claims these receipts ought to be attributed under Indiana law.
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> 45 IAC 3.1-1-62, the referenced regulation, states:

Special Formulas for Division of Income. All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. **It is anticipated** that these situations will arise only in limited and unusual circumstances (which **ordinarily** will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

(Emphasis added).

By using the audience factor, the Department followed the rules outlined in IC § 6-3-2-2(l) and 45 IAC 3.1-1-39 and -62, which govern the interpretation of Indiana's sales factor when uncontemplated apportionment issues are presented.

Taxpayer reads the language of limitation expressed in the regulation too narrowly. Clearly, the regulation strikes a cautionary note against the Department implementing its remedial powers broadly. However, the statute's language of limitation suggests a tolerance for "limited and unusual" circumstances which are only ordinarily unique and non-recurring; i.e., the circumstances may also be non-unique and recurring. The "audience factor" method of apportionment is being applied to a limited situation in the matter before the Department. The Department has the authority to apply IC § 6-3-2-2(l) to effectuate a result that more fairly represents taxpayer's income derived from sources within the state.

The plain language of the law states that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana... the department may require, in respect to all or any part of the taxpayer's business activity... the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." IC § 6-3-2-2(l). (Emphasis added). The "audience factor" is an appropriate method to effectuate an outcome that more equitably reflects the taxpayer's income from Indiana sources.

Taxpayer also argues that the Department's application of the audience factor violates the state's Administrative Procedure Act ("APA"). IC § 4-22-2-3(b) defines a "rule" as "the whole or any part of an agency statement of general applicability that: (1) has or is designed to have the effect of law; and (2) implements, interprets, or prescribes: (A) law or policy; or (B) the organization, procedure, or practice requirements of an agency." Taxpayer argues that the method applied by the Department on audit constituted a rule under this definition. In further support of this argument, Taxpayer cites to state supreme court cases from Maryland and New Jersey where the courts upheld an argument similar to Taxpayer's (see CBS Inc. v. Comptroller, 575 A.2d 324 (Md. 1990) and Metromedia, Inc. v. Director, Division of Taxation, 478 A.2d 742 (N.J. 1984)). Taxpayer further points out that the reference in the Department's audit to "agency action" under IC § 4-21.5-1 et seq. is not applicable since the Department is not subject to this article. On this latter point, Taxpayer is absolutely correct, the Department is not subject to IC § 4-21.5. IC § 4-21.5-2-4(a)(9). However, Taxpayer's argument that the Department's application of the "audience factor" method violates the APA is not correct, since the Department is applying IC § 6-3-2-2(l) and has been consistent in its application to Taxpayer and other similarly situated taxpayers. Lastly, other states' interpretations of their laws, while instructive, hold no precedential value in Indiana; and Indiana courts have not considered whether the use of the "audience factor" apportionment methodology constitutes a rulemaking action.

Pursuant to IC § 6-8.1-5-1(c), Taxpayer has not met its burden to show why the "audience factor" method of apportionment does not fairly reflect Taxpayer's corporate income from Indiana sources and why the "cost of performance" method would more fairly reflect Taxpayer's income.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax – Consolidation – Entities Added to Indiana Return.

DISCUSSION

The Department found that Taxpayer did not include one subsidiary cable network in its Indiana consolidated tax returns during the 2006, 2007, and 2008 tax years and, for the 2007 and 2008 tax years, did not include a network affiliate. The Department determined, under the authority of IC § 6-3-2-2(a), that Taxpayer had not properly reported income from licensing films and television shows to broadcast and cable networks which were then viewed on those networks by Indiana residents in their homes.

The Department's audit describes the first entity ("E1") as a cable programming provider that provides 24-hour per day network programming services to Indiana residents principally through third-party cable operators. The programming services include the production, creation, editing, and packaging of the cable television programs. E1 is described as a company that operates "three premium subscription television programming services" offering a variety of programming and also the "development, production, acquisition and, in many cases, distribution" of original productions. E1 was originally included in Taxpayer's Indiana consolidated

group; however, according to its protest, Taxpayer did not have Indiana employees or property for the years at issue.

E2 is a corporation that "engaged in the production and broadcasting of television programs" and, similar to E1, also the "development, production, acquisition and, in many cases, distribution" of original productions. E2 also owned and operated television stations, but none of the television stations were in Indiana.

Again, the Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1.

IC § 6-3-2-2(a) states:

With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

(1) income from real or tangible personal property located in this state;
(2) income from doing business in this state;
(3) income from a trade or profession conducted in this state;
(4) compensation for labor or services rendered within this state; and
(5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

45 IAC 3.1-1-38 defines "doing business in the state:"

Doing Business. For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

(1) Maintenance of an office or other place of business in the state
(2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
(3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
(4) Rendering services to customers in the state
(5) Ownership, rental or operation of a business or of property (real or personal) in the state
(6) Acceptance of orders in the state
(7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.

As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC § 6-3-2-2(b)-(n). (Emphasis added).

Taxpayer claims that, because these subsidiaries had neither a physical location nor personnel in Indiana, the income earned by these subsidiaries should not have been included in the affiliated group's income.

At the hearing Taxpayer argued that the "cost of performance" of E1 and E2's relevant activities all occurred outside Indiana. The effect of Taxpayer's argument is that E1 and E2 had no Indiana receipts pursuant to IC § 6-3-2-2(f) and 45 IAC 3.1-1-55. Coupled with the lack of Indiana property and payroll, Taxpayer's argument is that E1 and E2 did not have Indiana-source income for the specific years protested. Because E1 and E2 did not have Indiana-source income, they could not have been part of Taxpayer's consolidated return for the specific years protested.

In this case, as provided in Issue I above, E1 and E2 had Indiana receipts for the years in question in this protest. Thus, Taxpayer's protest is denied. However, even if Taxpayer's argument regarding the "cost of performance" as the legally required attribution method is accepted, Taxpayer has not provided the Department's hearing officer with sufficient factual grounds to conclude that the Department's audit was incorrect.

FINDING

Taxpayer's protest is respectfully denied.

CONCLUSION

Taxpayer is denied on the all issues of its protest.

Posted: 03/27/2013 by Legislative Services Agency
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